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SUBJECT: FALLING RUSSIAN RESIDENTIAL REAL ESTATE PRICES
TAKING THEIR TOLL

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FALLING RUSSIAN RESIDENTIAL REAL ESTATE PRICES TAKING THEIR TOLL

Summary

¶1. (C) Residential real estate prices have already fallen more than 28 percent since their October 2008 peak, with some market participants predicting total drops of 75 percent before prices hit bottom. Similar to commercial developers (reftel), "mass-market" Moscow developers owe billions of dollars, much of it short-term credit, which they are unable to repay. Insofar as homeowners and high-end developers are concerned, although mortgage arrears have more than doubled in the last quarter, relatively low levels of mortgage debt should mean relatively few foreclosures. That said, government initiatives to prop up demand have been unsuccessful to date and even dramatically lower prices are unlikely to allow many Russians to buy homes -- requisite savings are lacking and the mortgage market, thin to begin with, has all but disappeared as banks hoard funds. End summary.

Real Estate Prices Fall

¶2. (C) In recent conversations, real estate professionals have told us that Moscow residential real estate prices are predicted to drop from average highs of USD 6000-8000 per square meter (among the highest in the world) to USD 2000-3000 by the fall. While Moscow Mayor Yury Luzhkov stated in February that it was "wishful thinking" to believe that prices would come down, they in fact peaked in October 2008 and, by most reputable measures, have already fallen more than 28 percent on average, with sales few and far between. (Note: Figures are trend indicators. Since Russia has no recording or reporting mechanisms for real estate transactions, averages are derived from information that market participants choose to share, which is primarily the asking prices. End note.)

¶3. (C) Outside of Moscow, in cities such as Perm, the situation is actually worse. According to President and CEO Michael Belton of the embattled PIK Group's Storm Properties, prices have already fallen more than 30 percent in Perm and other provincial cities. Belton argued, however, that Moscow

was unlikely to see as severe a plunge. Even in 1998, he said, prices had not dropped more than 40 percent on average (USD 1200 to USD 700 per sq.m.) and he doubted that today's downturn would be worse, confidently predicting that the bottom would be reached "by late spring".

¶4. (C) Belton's view, however, is in the minority. Sergey Kanukhin, President of the Russian Realtors Guild told us that he did not expect to see Russia's economy improve until the end of 2010 and predicted steep reductions in Moscow real estate prices totaling up to 75 percent over the next six months. Olga Dergunova, former head of Microsoft Russia and current Vice President at Vneshtorgbank (VTB) in charge of real estate also told us that she expected a drop of 75 percent in Moscow real estate prices this year.

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Developers: "Mass-Market" in trouble; High-End Have Options
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¶5. (C) These price drops have put financial pressure on "mass-market" developers. For example, Belton,s PIK Group, a leading Moscow developer of "mass-market" housing, reportedly owes USD 1.5 billion of which USD 900 million is short-term. Reportedly PIK owed USD 265 million in foreign debt that came due this past fall and was able to avoid default only through two loans: USD 300 million from Vnesheconombank (VEB) and 11 billion RUR (approximately USD 370 million at today's exchange rate) from Sberbank. However, the company may have trouble borrowing any additional funds. It has lost 98 percent of its value since last summer, in the process wiping out shareholder value.

(N.B. Many of the shareholders are believed to be foreigners who participated in PIK,s successful 2006 London IPO, which raised USD 1.85 billion.)

¶6. (C) The company's future took another hit recently when, after it announced that it had USD 1 billion of housing contracts from Moscow City, the City refused to pay PIK's asking price. The final contract was reportedly for only USD 145 million. While Belton tried to put a good face on PIK's future, Julia Gordeyeva, Deutsche Bank Vice President and Real Estate Analyst, told us that PIK was trying to decide whether to collateralize 60 percent of its company in order to refinance a debt coming due soon on which it would otherwise probably default.

¶7. (C) According to Gordeyeva, the future remains equally precarious for a number of other "mass-market" developers, such as LSR, SU-155, Glavmosstroi (owned by embattled oligarch Oleg Deripaska), and Mospromstroimaterialy. Analysts estimate their combined debt to be about USD 7 billion, with all of them having to refinance hundreds of millions of dollars worth of loans with Russian banks in order to finish projects. Gordeyeva noted that while their government connections appear to have assisted them in refinancing and staving off liquidation in the past, dwindling government resources made that less likely in the future. Moreover, she noted it would take USD 50 billion in GOR cash injections to complete the housing projects that were already under contract.

¶8. (C) In addition, government efforts to assist these developers have not been well-designed. Prime Minister Putin has proposed using the crisis as an opportunity to buy apartments for veterans and other government dependents, but Belton told us that most recent builds were "business" and "luxury" class properties. These would not be within government budgets and "mass-market" developers were not ready to sell below cost or even reduce prices significantly. Indeed, recently in St. Petersburg, the government was unable to buy a single apartment at the fixed price it offered developers.

¶9. (C) Unlike the mass-market developers, most higher class residential developments are equity financed, which gives those developers more latitude to "wait out the crisis" for the time being. Mark Groysman, General Director of the Sawatsky Group, a developer of high-end residential projects, confirmed to us that demand had dropped precipitously for his projects. However, Groysman said that while he was willing to sell at "below market" prices, the discount was relatively small -- just enough to "keep the cash flow positive". He further cautioned that such prices could only be obtained by "trusted" buyers whom management knew personally. Groysman added that developers were chary of allowing discounted sales prices to become generally known, for fear it would lead to more downward pressure on prices.

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Weak Mortgage Market Limits Options for Russian Consumers
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¶10. (C) Most Russians will not be able to take advantage of even sharp drops in asking prices to purchase a new home. The mortgage market, which had not really gained traction prior to the credit crunch, was one of the first to shut its doors. Leonid Grigoriev of the Institute for Energy and Finance told us that tightening credit market had forced most banks to close down mortgage operations. Kanukhin told us that financing was currently available only at a staggering 50% down-payment, with interest rates running at about 28% and rising. Furthermore, such terms were only available for existing structures, not new builds. Banks, according to Kanukhin, were simply not willing to risk funds on uncompleted projects.

¶11. (C) Regardless of bank terms, Russians themselves are increasingly reluctant to take on debt. Natalia Bondarenko, a sociologist at the Levada Center said that even in 2005-2007, the heady days of "ever-rising" prices, data showed that only 2-3 percent of Russians had taken out loans for real estate purchases. Russia's mortgage debt prior to the crisis was calculated to be about 2 percent of GDP. (Note: U.S. mortgage debt is almost 80 percent of GDP. End Note.) Now, with Russians feeling increasingly apprehensive

about the country's economic future, mortgage debt has become even less appealing, despite GOR efforts to bolster the market with initiatives to subsidize interest rates.

¶12. (SBU) Press reports indicate that arrears for ruble-denominated mortgages doubled in the last quarter to 5.8 billion RUR (approximately USD 160 million). For dollar/euro-denominated mortgages, the figure tripled to 6.3 billion RUR (approximately USD 175 million). The mortgage market's shallow penetration has meant, however, that sinking values do not leave Russian borrowers owing more than their dwelling is worth (i.e., negative equity). Nominal property tax rates further reduce financial pressures. The result, according to experts, is that foreclosure remains an unlikely scenario for the average borrower.

Comment

¶13. (C) Defaulted home mortgages are unlikely to be a major problem in Russia and we are unlikely to see a wave of foreclosures despite sharply falling real estate values. However, outstanding loans to residential "mass-market" developers, as well as other commercial developers, will likely comprise a large chunk of the non-performing loans (NPLs) that are threatening what Finance Minister Kudrin this week called a second Russian banking crisis (septel).

¶14. (C) Moreover, the drop in housing values will negatively affect Russians' perception of their wealth. During the Putin years, upper middle class Russians throughout Russia

felt that real estate was the safest investment and used excess cash to purchase an apartment, with Moscow as the destination of choice if financially feasible. Even without foreclosures, the fall in real estate values therefore could add to growing social discontent.
BEYRLE